A Painfully Topical Issue

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Ethical Control in the Planning, Management and Auditing of the General Government and Public Finances

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Institutions matter, i.e. institutional environment is highly significant from the aspect of economic performance and efficiency; this was the theory elaborated on in 1993 by *Douglass C. North,* which has since then become a staple of mainstream economics and one which brought him the Nobel Prize in economics. In this context, institutions are the social rules and frameworks that limit human interaction. Therefore, institutional environment encompasses all things that narrow down decision options, be it codified regulations or ethical norms adhered to by the majority. Even though these latter are impossible to enforce legally, given their embeddedness they are essential parts of the institutional matrix.

The novelty in North's approach was that in contrast to classical and neoclassical economists, he argued that laws, norms, culture, religion and collective memory all play a role in how successful a country is, as these factors determine the actual consequences of various economic decisions. This is especially true in the field of economic policy and public finances, where temptation to make decisions based on abstract ideologies instead of realities is great, but due to the diversity of institutions, actual impact might vary across countries. This is why the publication of *Endre Béla Huff*'s book *Ethical Control in the Planning, Management and Auditing of the General Government and Public Finances* is such a joyful occasion as it addresses precisely that highly sensitive issue, which, until now, has remained virtually unaddressed in Hungary.

Adam Smith and *David Ricardo*, the two founding fathers of modern economics wrote about the fruitful labour of the market's invisible hand and the blessings of free market conditions at a time when traders and bankers did business by verbal agreement and handshake and written forms of such contracts existed purely as reminders of their given word. England and Scotland of the 18th century are, however, things of the past and parties doing business today often know nothing about each other except for online usernames and passwords. If I do not know my business partner, I only have those rules to trust that everyone must adhere to; the only problem being that not everything can be set out by codified statutes and both the economic and the judicial system would break down if every petty case were to end up in court. This is the reason why unwritten rules are so important: an ethically operating economy and state are much less costly than those operating without ethical points of reference.[1]

If there is any field where ethical rules are outstandingly important, it is the use of public monies, as the operations of the state are ultimately based on the trust between its leaders and its citizens. This is why economic policy is such a special area of economic life, since in order to achieve success, apart from good professional decisions, it is also necessary that the masses of constituents accept, and indeed, support the objectives. In a politological approach, it could be argued that successful economic policy requires political capital. This in turn requires trust, which assumes that political leaders should be seen by citizens not only as law abiding, but also as ethical.[2] "Ethical control is necessary in the interest of creating and securely operating a public finance system that behaves responsibly towards society," Endre Béla Huff summarises.

According to the author, "the main question today is not whether ethics and morals play a part in economy and finances, but rather how they do this," which clearly indicates that the role of ethics has not always been so obvious. Though it is a fact that Adam Smith laid down the foundations of modern economics as a moral philosopher, in the two hundred years following his work, ethical considerations have been gradually edged out of economic investigations. According to the classical school of thought, due to the invisible hand that creates public good from being driven by self-interest, ethical considerations have no place in the field of economic thinking: everyone should consider their own interests above all else as this is beneficial for everyone. This rather simplifying statement was not the position of the founding fathers of economics; it was developed later on. Smith stated nothing more than that the great advantage of the market was its ability to function regardless of the existence of selfish people, which is not equal to considering selfishness an ethical behaviour. Integrity, decency and adherence to basic moral principles was such an obvious thing at the time that there was no need for special emphasis to be placed on the matter. However, Smithsonian economic theory became distorted over time, which is well reflected by the fact that one of the most influential American philosophers and thinkers of the early 20th century, *Ayn Rand,* wrote a book on moral egoism entitled *The Virtue of Selfishness*, according to which helping others is harmful overzealousness and degrading to others.

The corporate and budgetary scandals of the last decade, however, have significantly weakened the approach denying the importance of morality. A tell-tale sign of the failure of market coordination that ignores ethical considerations was the 1995 collapse of Barings, one of the oldest banks in London, the Enron scandal that rocked the very beginning of the 21st century, the demise of Arthur Andersen, once one of the biggest accounting firms in the world, or quite recently the American mortgage crisis that set off the current economic downturn that was, at least in part, a result of the wholly opaque securitisation process. The absence of ethical standards has clearly lead to emergencies at state level as well; the debt crisis of the Euro Area, the accounting scandals and tricks of various Member States now pose a veritable threat that could lead to the collapse of the common currency zone. It is an 'achievement' of ten years that one cannot fully trust statistics and reports either by corporations or the state.

Mainstream economics has been addressing ethical issues again since the 1980s[3], and today practically all universities of economics have courses and departments dedicated to business ethics. In the majority of cases, the ethical aspect concerned the responsibility of companies, i.e. whether or not businesses should also pursue other social goals besides profit objectives. Virtually all economists agree that the concept of ethics-free economics[4] cannot really be maintained today, as adherence to certain moral values is required for the market to be truly efficient; simply because due to externalities and other market failures individual and social costs may differ.[5]

Typically, economists have not dealt with ethics related to public finances, which is presumably due to the fact that public affairs ethics are largely considered a political matter. A political power or government that behaves unethically will lose the trust and confidence of constituents as well as the elections, which means that ethical aspects are automatically enforced in democratic societies and as such do not have to be dealt with separately. However, the situation is not as simple as that: the relationship between ethical behaviour and election performance is not as strong as it is suggested by the above reasoning; therefore, related research is definitely justified.

It is already difficult enough to answer the question what ethics, morals, virtues and norms are exactly. Are these absolute rules[6] or consensus values?[7] Is it the outcome or the process of our actions that should adhere to certain rules and regulations in order to be considered ethical? How does a moral imperative become a norm and how is it more than taste?[8] Can we call following externally enforced rules and regulations ethical or do we only consider it ethical if we are internally bound by a rule? Is rational behaviour contradictory to ethical behaviour? What is rationality? Internal consistency or self-interest?[9]

Endre Béla Huff does not go into the theoretical debate represented by these issues, but his book can still be considered a significant contribution to academic literature. By his definition, ethical control determines the relevant norms of the given social environment, makes them usable and standardises them for the players of the economy, who are thus expected to enforce these when making their decisions. The author attaches great significance to these 'standardised virtues' and places humanity, economy, transparency and cooperation in this category. Understandability would improve if the author elaborated on how the tension between being standardised and the ethics related to voluntariness could be resolved, particularly in light of the fact that at the beginning of the book he himself writes: "a virtuous person is one who, when making an ethical decision, does so correctly and morally by his or her nature," i.e. does not act ethically under external pressure.

According to Endre Béla Huff, an institution can also be virtuous if it "bases its operation on professional and general virtues." In relation to this, the author highlights that planners and organisers of the general government must realise that the utilisation of 'humanised' economic programmes that have been 'socialised' based on ethical considerations will provide a return on investment for them as well. However, in order to achieve this, instead of performing their tasks as politicians they must act as 'professionals'. According to Endre Béla Huff, pushing political considerations to the background would improve efficiency; however, he does not detail how this could be put into practice, i.e. how political logic could be exiled from the political system. It is also unclear whether this often heard notion would indeed make the management of public finances more efficient. "Public law is highly lenient towards politicians, while the activities of the institutional apparatus of public finance are being limited," he claims. It is the author's view that ethical standards must be developed that require, for example, that politicians live up to their campaign promises, or for such undertakings remain within the realm of rationality. Without any doubt, these suggestions meet taxpayer interests; however, the details of implementation, which promise to be rather difficult, have unfortunately been left out of the book. As such, the suggestions are more of a thought experiment.

"Ethics will once again enforce its rights in business life; not through force or as a result of external administrative intervention, but due to the ability of the world economy, globalisation, the modern media and Generation Y to exert pressure," Huff argues. Pressures from the world economy and globalisation are results of Keynesian economic policy, ecological problems and the conflict between the centre and the periphery, while the power of the media, which the author calls the greatest power, a 'factor of world power', is derived from public pressure. Interestingly, the positive attributes of the youth ('Generation Y', the yuppies), simply considered by many as consuming beings, are highlighted at the same time: the author points out that ethical norms are spread and enforced due partly to the fact that a generation that is at once "rational, tough, steady and ethical" is coming of age. "They possess business ethics and social morals that their seniors did not, not even when they were younger; doing business in an ethical manner comes naturally for them," Endre Béla Huff says, which is also supposed to mean that there is reason to be optimistic and that the world view of youth will restore the order of things.

According to Endre Béla Huff, we are witnessing a paradigm shift in the relationship of real economy and ethics. "The classic role of safeguarding the pure conditions of market economy is now complemented by the examination of transparent conditions, which is a more comprehensive task. The movement of public funds must be monitored from planning to utilisation," the author argues, thereby offering a summary of the basics of modern public auditing in a manner clear and understandable to all. This is what the public finance shift experienced in Hungary over the last year is all about: actual control, efficient auditing and implemented recommendations are required; reports and recommendations shoved to the back of the drawer are a luxury no society can afford in today's world.[10] "Setting up controllable institutions and ensuring their operation through legislation is insufficient: the critical recommendations they put forward must also be followed," the author clarifies.

"Moves along the border-line with a unique, individual approach," says of Endre Béla Huff's book *Árpád Kovács*, the book's editor, former President of the State Audit Office of Hungary, according to whom this perplexing approach could induce identification, astonishment, dismissal, or even anger in the reader. It is a fact that the work reviewed does not follow the usual standards either in structure, or approach, or train of thought. It is undoubtedly difficult to understand, for example, why the author discusses at such a great length the history of the evolution of economic and ethical principles, especially taking into account that later on in the book he does not revisit the usability of historical experiences today. Mentioning *Xenophon*, *Aristotle*, *Plato*, the Carolingian emperors, *Hobbes*, *Smith* and *Mandeville* seems exaggerated: the book's train of thought would be easier to follow if they were not explained in detail. At the same time, the author's treatment of the issue of corruption, which is highly significant from an ethics point of view, may be very narrow in scope, although the fact is certainly commendable that he points out the complexity and dual nature of the relationship of the economy and corruption. Most comments and observations regarding corruption are oversimplifying in nature and do not take into account what the author emphasises: corruption sets economic performance back, while a low level of development itself is one cause of corruption.

Reading the whole book does indeed require great resolve, but I can safely say that it is worth getting through it for anyone who deals with public finances, auditing or ethics as part of their profession or simply out of general interest. "The world can indeed be seen in the way Endre Béla Huff shows it," Árpád Kovács writes in his foreword, recommending this 'intellectual adventure' to the readers. I will do the same: while the book does not provide satisfactory answers to each of the problems it addresses, and is far from being an easy read, it does deal with a problem set that will largely determine the development of the world around us, and as such, it is definitely a worthwhile book.

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Notes

[1] The reformation of the Hungarian Fiscal Council in 2010 and 2011 is a prime example that in order to be able to follow on from a government engaged in unethical conduct, an institutional solution is required that significantly decreases the flexibility of economic policy. Ideally, the credibility of the economic policy would allow for the establishment of a less strict and powerful council.

[2] This idea is also reflected in the Founding Declaration of the Institute for Capitalism and the Public Good, an institute promoting institutional thinking. According to the Declaration, "good capitalism builds on the freedom, integrity and trust of the people; the respect for knowledge and performance; and the acceptance and credibility of institutions and regulations governing public affairs".

[3] On November 5, 1990, the Pontifical Council for Justice and Peace held a large-scale conference in Vatican City on the issues of business ethics. Among the lecturers were such distinguished economists as Kenneth J. Arrow, Robert E. Lucas Jr., Jeffrey D. Sachs or Amartya Sen. The lectures presented at the meeting were published in 1993 under the title Social and Ethical Aspects of Economics.

[4] The lack of ethical behaviour was deduced by Nobel laureate Robert E. Lucas Jr. using the human model of economics. "Economics does not have or imply a view of the nature of man. Economics is a method for understanding human behaviour that works through the construction of artificial, fictional people—robots, one might say—and the study of the workings of artificial economic systems made up of such agents. The idea is that by studying the behavior of highly simplified theoretical systems we can gain understanding of the way actual societies respond to changes in their situation. An 'economic man', which is to say a constituent robot in an artificial economic system, is typically so constructed as to be perfectly rational (and hence perfectly understandable) in a way that actual people never are." Robert E. Lucas, Jr: Ethics, Economic Policy and the Understanding of Economic Development. In: Social and Ethical Aspects of Economics. A Colloquium in the Vatican. Egyházfórum, 1993

[5] According to neoclassical economics (especially Milton Friedman), it is the moral duty of a company to provide quality services in a timely manner, as well as to respect rules and agreements. Kenneth Galbraith accepts that companies act out of self-

interest, but in his view this is driven towards public good not by the 'invisible hand' of the market, but the 'regulating hand' of the law. The responsibility of companies from this aspect is to respect the laws, i.e. again, companies do not have to make moral decisions. According to the concept of responsible corporate management, not only should company executives follow purely economic goals, they may also consider different aspects when making decisions (this is the 'hand of corporate management').

6 "Ethics are lessons on correct living, i.e. on correct actions and correct behaviour." Peter Koslowski: Ethics of Capitalism, or Private Vices Will Not Be Turned into Public Benefits. In: Kindler and Zsolnai: Etika a gazdaságban (Ethics in the economy)

7 "In a pluralistic society there is no agreement as to what is morally right and wrong." A decision therefore is ethical only if the parties to be impacted by it are able to come to a rational agreement concerning it. "Do only unto others what you and the others have agreed upon." Peter Pruzan and Ole Thyssen: Conflict and consensus: Ethics as a shared value horizon for strategic planning. In: Kindler and Zsolnai

8 A norm is a moral statement about a rank order of preference among alternatives which is intended to apply to more than one person, whereas a preference that applies to only one person is a 'taste'. Kenneth E. Boulding: Economics as a Moral Science

9 Amartya Sen: Some Contemporary Economic and Social Issues

10 The 2011 Act on the State Audit Office of Hungary, which set the exact same objectives, is a case in point.

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